II. INTERNAL CONTROL

INTRODUCTION

Internal Control is a plan of organization under which employees' duties are so arranged and records and procedures are so designed as to make it possible to exercise effective accounting control over assets, liabilities, revenues and expenditures. Under such a system, the work of employees is subdivided, wherever possible, so that no single employee performs a complete cycle of operations. In addition, the procedures to be followed are established and require proper authorization by designated officials for all actions to be taken.

Internal control provides management with reasonable assurance that its policies and procedures are implemented and consistently followed to ensure efficient and effective organizational operation. The traditional system of an internal control plan consists of all the methods used to safeguard assets, to promote accuracy and reliability of the organization's accounting data and records, to encourage compliance with all policies and procedures prescribed by management, and to promote the operational efficiency of the organization.

While each agency's control structure consists of a large range of policies and objectives, one of the key elements critical to assurances on the financial statements as defined by the American Institute of Certified Public Accountants (AICPA) Professional Standards AU319.06 is control procedures. Some of the basic objectives implicit to control procedures are as follows:

- Transactions are properly authorized.
- Duties are sufficiently segregated.
- Access to assets is limited in accordance with management's authorization.
- A comparison or check of recorded assets with existing assets is performed by staff independent of the financial area responsible for recording the amounts.

A. MANAGEMENT'S RESPONSIBILITY

Designing, installing, and maintaining a system of internal controls is an integral part of the management function. A key ongoing objective of the State's Financial Officers is that all levels of responsibility and authority operate in an environment with internal controls.

B. METHODS OF ACHIEVING INTERNAL CONTROL

One of the basic and most successful methods of achieving internal control is through the segregation of duties. The segregation of duties divides the responsibility for a transaction or activity among different parties so that no one employee has complete control over the processing of transactions. This method of control increases the likelihood that if one person makes an error, another will discover it. Segregation of duties also reduces the risk that one person would perpetrate and/or conceal errors in the normal course of his or her duties.

A rule of thumb in establishing proper segregation of financial duties is that the party that has access to or possession of an asset should not be the party that maintains the accounting records for the asset. A few simple examples might be:

- The division of responsibility for accounts receivable records and cash receipts.
- The preparation of a monthly bank reconciliation by an employee not responsible for disbursing checks or depositing cash.
- The division of responsibility between a person with the ability to enter or change data in an automated system and a person who provides the approval for the transaction.

While segregation of duties is usually a superior method of achieving internal controls when compared to other methods, it is not always practical in a small agency with limited staff. When the segregation of duties is impossible or impractical, management should look for other methods of ensuring internal control such as regular periodic supervisory reviews, rotation of duties, edits built into automated systems, unannounced verification of assets, etc.

C. ESTABLISHING CONTROLS OBJECTIVES

Internal control systems vary from one entity to another. The control objectives and features are dependent on the organizational complexity of an entity and management objectives for that entity. Regardless of the differences in entity size and technical specialization, however, certain characteristics must be present in all systems.

- A structural plan of the organization that provides the framework for the division of authority, responsibility, and duties in an appropriate manner.
- An accounting system designed to measure results of operations and financial position.
- Personnel policies designed to employ, train, evaluate and compensate employees.

While the above control objectives are broad enough to provide management with reasonable assurance that its policies and procedures are being carried out, these objectives are too general to help the financial managers design or evaluate a system of accounting controls. The following specific control objectives are widely accepted as elements of good control and should be used by management and financial managers:

- Authorization – ensuring that all transactions are approved by management.
- Validation – ensuring that recorded transactions represent real transactions.
- Capture – ensuring that all transactions are recorded.
- Valuation – ensuring that all amounts recorded for transactions are accurate.
- Classification – ensuring that all transactions recorded are assigned to the proper categories (i.e., assets, liabilities, revenues, expenses) and subcategories (i.e., type of expenses).
- Cut-off – ensuring that transactions are recorded in the appropriate accounting period.
- Access – ensuring that only authorized individuals, consistent with their job responsibilities, have appropriate access to assets.

A well designed system of controls must include written policies and procedures to ensure that each control objective is met. Failure to meet control objectives constitute a weakness in the agency's internal control system.

D. LIMITATIONS OF INTERNAL CONTROLS

Internal controls are not foolproof. If not monitored, the control system tends to deteriorate and become ineffective over time. Management's monitoring of and attitude toward adherence to control procedures is critical to making controls work. As stated, the objective of internal controls is to provide reasonable assurance that management's policies and procedures are being carried out. The concept of reasonable assurance recognizes that the cost of the system of internal accounting controls should not exceed the benefits expected to be derived, and also recognizes that the evaluation of the cost-benefit relationship requires estimates and judgments by management.